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Pension Integration - Issues and Complications

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I am grateful for the opportunity to present our views on pension integration and to discuss some of the issues in designing an integrated pension plan.

United Technologies Corporation sponsors 50 domestic pension plans covering over 100,000 employees. Our plans provided \$160 million of benefits in 1983 to 40,000 retired members. Plan assets equal \$3.5 billion. In 1984 UTC will contribute \$203 million to fund the pension plans.

UTC also contributes to another pension program ... Social Security. The 1984 contribution for Social Security retirement benefits will be \$140 million. Our employees will contribute an equal amount. This is exclusive of our contribution to the Health Insurance component of Social Security.

The 50 UTC plans can be categorized into plans which are implicitly integrated with Social Security, generally plans covering union employees, and plans which are explicitly integrated, generally plans which cover employees not represented by a union. I would like to concentrate on the latter category: the explicitly integrated plans.

Let us consider the characteristics of the largest UTC pension plan, which is explicitly integrated:

33,000 employees  
21,000 retirees  
\$2.2 billion assets

The retirement benefit formula is:

2% salary times the first 20 years service and 1% salary times service after 20 years, integrated with 50% of Social Security benefit.

For our average employee the monthly benefit will be:

UTC Pension	\$ 850
Social Security	<u>750</u>
Total	\$1,600

For employees at the lower and higher income ranges, the monthly figures are:

	<u>lower salary</u>	<u>higher salary</u>
UTC Pension	\$ 600	\$2,070
Social Security	<u>550</u>	<u>750</u>
	\$1,150	\$2,820

Social Security benefits are better as a percent of pay for low wage earners. The system was designed that way to meet the basic needs of all retired workers. It is appropriate for a national social program to emphasize social adequacy.

UTC's pension program was designed with a goal of equitable benefits for all employees across the earnings range. Thus we believe a medium or higher paid employee should receive a benefit percentage from the combination of Social Security and our pension plan that is commensurate with the percentage for a lower paid employee, given similar service. Differences in the benefit percentages should reflect work related expenses, relative tax positions and amounts of disposable income. We have chosen to emphasize individual equity. Applying the rules for integration to our plan produces a combined benefit percentage (replacement ratio) which decreases as compensation increases, although not to the same degree as does the Social Security benefit by itself.

Let us review the two major considerations that all plan sponsors should start with in designing an integrated pension plan. We would attempt to set a benefit level sufficient to attract, retain, and motivate competent employees. Benefits would be large enough to allow aging employees to retire with financial security. We would also determine the cost of the benefit program and adjust the benefit level as necessary.

In setting an appropriate benefit level we need to take Social Security into account. If we did not, one of two results would occur:

- o certain employees would receive very high combined benefits while other employees would receive inadequate benefits.

- o the cost of the program would be substantially higher than justifiable.

UTC does not have an unlimited budget for the proper funding of our pension program. Thus we cannot ignore the substantial benefits our employees derive from the Company contribution to Social Security. Integration with Social Security allows the most efficient benefit delivery for all employees from the contribution level that we have allocated.

A public employee retirement plan funded through tax revenue has the same considerations when the participants are covered by Social Security. A benefit structure must be designed to meet the retirement needs of a broad spectrum of employees, and at the same time avoid an undue financial burden on the taxpayers.

#### ISSUE

Consider the salary range for the group of employees to be covered by a new pension plan. If a narrow range exists, the Social Security replacement ratio is about the same for all employees. Integration can be accomplished implicitly, and the complementary pension replacement ratio can be determined.

If the salary range is broad, proper integration can only be accomplished explicitly, i.e., by directly mentioning the Social Security benefit in the pension plan formula:

**Examples:**

- o 50% of final average pay integrated with 50% of Social Security benefit
- o 1½% of final average pay integrated with 1½% of Social Security benefit, for each year of service, maximum 35 years

**ISSUE**

Social Security benefits are calculated using the earnings over an employee's entire career. How much credit for Social Security benefits should the company take for someone who is not a full career employee? There are basically two ways this is now handled:

- o calculate the Social Security benefit using only earnings while in company employment,
- o calculate the Social Security benefit assuming a full career of earnings, then prorate according to actual service with the company,

UTC uses the first method in determining Social Security benefits for our integrated benefit formula. Note, however, that government regulations do not require any reduction in the integrated Social Security benefit for employees with less than a full career with the company.

### ISSUE

What if an integrated formula results in little or no pension benefit for lower paid employees? One solution would be to increase the pension formula for everyone. This is the expensive way. A better way is to establish a minimum benefit from the pension plan.

For example:

50% final average pay integrated with 50% of Social Security, with a minimum benefit of \$10 for each year of service.

At UTC, the minimum benefit provision operates to assure a pension benefit for every retiree.

### ISSUE

One of the major issues in inflationary times is the relative roles of Social Security and pensions after retirement. None of UTC's pension plans contains an automatic increase provision for post-retirement inflation. Such a provision is expensive and is uncommon among large companies.

Instead, in periods of high inflation, a company will often grant one time adjustments to current pensioners to help them maintain their standard of living at retirement. UTC granted such an increase, called an "ad hoc" increase, in 1979. There are three reasons we have not given additional ad hoc increases:

- o they are quite expensive,
- o Social Security benefits are fully indexed for inflation,
- o inflation has moderated.

It is interesting to note that a lower paid employee receives a larger proportion of his total retirement benefit from Social Security than a higher paid employee. Thus the lower paid employee has a greater degree of inflation protection and is better able to maintain his standard of living at retirement. Higher paid employees, with relatively less inflation protection, generally have other sources of financial security to help maintain their standard of living.

In addition to our basic pension plan, UTC also sponsors a defined contribution savings plan. This plan is viewed as a supplemental plan. The company matches 50% of the employee's contribution of up to 6%. Assets accumulated at retirement will help improve our employees' financial security. Our savings plan is not integrated with Social Security.

#### ISSUE

With all the complex calculations for Social Security benefit determination, how can an integrated system be efficiently managed?



It is imperative to rely on a computer system for benefit calculations. The system must be reliable, efficient, and flexible. At UTC we maintain employment records for 60,000 employees on our data base system. When an employee is contemplating retirement, our pension technicians work interactively with the system to produce a pension status sheet. This provides a summary of all benefit and options. The Social Security benefit is automatically calculated through a subroutine installed and maintained by our actuarial consultant. The pension status sheet allows a retirement counselor to discuss accurate pension benefits with each employee nearing retirement.

#### ISSUE

What are the considerations in communicating benefit information to employees? An integrated benefit formula has the stigma of being difficult to communicate. This is likely due to the negative connotation of an "offset" component in the formula.

The most effective way to tell an employee about his pension benefit is to give him a personalized benefit statement. UTC provides annual benefit statements to all employees covered by the integrated pension plan. Accuracy and clarity are essential in benefit statements. The data for calculating benefits is accessed from the same data base used for recordkeeping.

Our benefit statement shows the benefit an employee is expected to receive at retirement from the pension plan and separately from Social Security. We concentrate on the results produced by the integrated benefit formula, not on the step-by-step process of deriving the benefit.

#### CONCLUSION

A pension plan integrated with Social Security is a highly efficient vehicle for delivering equitable retirement benefits. Proper design and management are essential for a successful program.

In the future, as design and financing questions arise, I would be pleased to discuss them with you.